



THE METROPOLITAN WATER DISTRICT
OF SOUTHERN CALIFORNIA

• **Internal Audit Report for July 2010**

Summary

Five reports were issued during the month:

- **Real Property Recordation Program Audit Report**
 - **Other Income, Expense, and Receivables Audit Report**
 - **Purchasing Audit Report**
 - **Audit Department Quality Assessment – General Conformance**
 - **Official Statement for the Water Revenue Refunding Bonds, 2010 Authorization, Series B**
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Discussion Section

This report highlights the significant activities of the Internal Audit Department during July 2010. In addition to presenting background information and the opinion expressed in the audit reports, a discussion of findings noted during the examination is also provided.

Real Property Recordation Program Audit Report

Background

Once the Colorado River Aqueduct (CRA) alignment was established in the 1930s, federal lands were purchased for the construction of the facilities and for right-of-way access to the project. Common practice at that time did not include the formal issuance of a property deed, nor did it include the installation of permanent boundary monuments at some locations. Under California law, Metropolitan may be at risk of losing its property rights if the federal government makes an error by selling overlapping property rights to another entity, and that entity records the deed in California. Most of this property had not been surveyed in over 70 years, and few visible boundary markers exist that delimited Metropolitan properties from adjacent federal, tribal, and private lands.

In 2003, Metropolitan initiated the CRA Real Property Recordation Program (Program) to rectify these concerns. The Program consisted of two board actions: First in September 2003 for \$1.9 million; and second in October 2003 for \$22.8 million. With these actions, the Board authorized a comprehensive eight-year plan to perform the field survey work to accurately locate properties, set visible boundary markers, identify encroachments, and record precise boundary mapping with the local county agencies. The Board directed staff to prioritize the work to initially address the more critical areas and authorized four-year professional services agreements to perform the initial work.

In February 2004, Metropolitan entered into consulting agreements with ten professional firms to perform land surveys for the Program. These contracts expired in 2008 with approximately 55 percent of the project completed. In September 2008, Metropolitan entered into consulting agreements with Rick Engineering Company (97270), David Evans & Associates (97263), and Psomas (97264) in amounts not to exceed \$2 million for each agreement. These agreements were part of the ten consulting agreements approved by the Board to complete the remaining work in the CRA Program, and were the subject of this review.

The scope of services under the agreements includes providing professional and technical services for field surveys, researches, site reconnaissance, and making electronic field measurements. It also includes performing survey adjustments and analysis, computer-aided mapping, map recordation processing, accurately locating facilities, identifying encroachments, and installing permanent property markers. Under the terms of the agreements, no work was guaranteed to the consultants and Metropolitan authorized tasks as needed. As of March 2010, payments to the consultants for the three agreements reviewed totaled \$2.8 million. There have been no amendments to these agreements and they expire in August 2011.

Opinion

In our opinion, the accounting and administrative procedures over Consulting Contracts – Real Property Recordation Program include those practices usually necessary to provide for a generally satisfactory internal control structure. The degree of compliance with such policies and procedures provided effective control for the period from August 2008 to March 2010.

Comments and Recommendations

COMPLIANCE WITH TERMS AND CONDITIONS OF THE AGREEMENT

Compliance with contractual requirements is necessary to ensure accurate accounting records, proper supporting detail, and adequate control over the administration of the agreements. Compliance with the contractual terms and conditions also ensures that parties fully discharge their duties and obligations and exercise their legal rights with associated agreements.

Our review of 27 selected invoices totaling \$194,012 revealed:

1. David Evans & Associates (DEA) was underinsured by \$500,000 for its workers' compensation liability. The agreement requires that DEA provide a \$1.0-million insurance coverage for its workers' compensation.
2. Business Outreach Program (BOP) requirements for the Rick Engineering Company (REC) agreement were inconsistent with DEA, Psomas, and other consulting agreements. The agreement does not require the REC to utilize the services of small and/or disabled veterans' business enterprises, and to submit the Small Business Enterprise (SBE)/Disabled Veterans Business Enterprise (DVBE) Utilization Report with each invoice. As a result, SBE/DVBE Utilization Reports were not attached to the invoices on a consistent basis.
3. Three DEA invoices tested were not attached with SBE/DVBE Utilization Reports, in contrast to the BOP requirements of the agreement.
4. The review identified one consultant payment percentage in the agreement administrator's tracking spreadsheet that was not reconciled to the recorded payments in the Oracle-Accounts Payable system. Although this was not a payment issue within Oracle, it did result in an incorrect percentage of completion for one task order.

We recommend that the agreement administrator resolve the noted differences and remind the consultants of the need to comply with the terms and conditions of the agreement. We also recommend that the agreement administrators establish procedures to ensure compliance to the terms of the agreement and conduct periodic reviews to ensure compliance.

Other Income, Expense, and Receivables Audit Report

Background

Other Income and Expense is a component of Metropolitan's annual Statement of Revenues, Expense, Changes in Net Assets, and monthly Statement of Operations. Other Income items include annexation charges, property rentals, gain on disposal of equipment, earnings on escrow accounts, vendor rebates, and other nonoperating revenue. Other Expense items include arbitrage rebate tax, bond-marketing expense, loss on sale of fixed assets, and miscellaneous interest expense. For the audit period (21 months) ending March 2010, Other Income totaled \$11 million, and Other Expenses totaled \$5.8 million resulting in net other income of \$5.2 million.

Opinion

In our opinion, the accounting and administrative procedures over Other Income, Expense, and Receivables include those practices usually necessary to provide for a satisfactory internal control structure. The degree of compliance with such policies and procedures provided effective control for the period July 2008 through March 2010.

Comments and Recommendations

There were no material findings to report.

Purchasing Audit Report

Background

The Procurement Team ("Purchasing"), of the Business Service Section is responsible for purchasing Metropolitan's materials, supplies, and nonprofessional services. Metropolitan utilizes several purchasing methods including purchase orders, blanket orders, and master contracts. The procurement process involves initiating a purchase requisition, obtaining proper approvals for the requisition, acquiring competitive bids, and creating and administering the purchase contract in accordance with Metropolitan Policies and Procedures and the Uniform Commercial Code. Procurement activities are processed and tracked through the Oracle purchasing application.

During the 24 months ended June 30, 2009, Purchasing processed 10,473 materials, supplies and nonprofessional services contracts (9,270 standard purchase orders, 407 blanket orders, and 796 master contracts) with a total requisition value of \$249 million.

Opinion

In our opinion, the accounting and administrative procedures over the purchasing process include those practices usually necessary to provide for a satisfactory internal control structure. The degree of compliance with such policies and procedures provided effective control for the period from July 2007 through June 2009.

Comments and Recommendations

There were no material findings to report.

Audit Department Quality Assessment – General Conformance

Background

Today's Internal Auditor is expected to profess a high degree of professionalism, independence, and integrity. In order to ensure that the Audit Department exhibits these qualities, we adhere to the Code of Ethics and the International Standards for the Professional Practice of Internal Auditing (*Standards*) set forth by The Institute of Internal Auditors (IIA). The *Standards* present mandatory guidance for the professional practice of internal auditing, establish a framework for performing value-added internal audit activities, provide the basis for evaluating internal audit performance, and foster improved audit operations. Specifically, an integral requirement of the *Standards* involves the implementation of a quality program to promote continuous improvement in the Audit Department. Accordingly, we have executed a Quality Assurance and Improvement Program (QA&IP) encompassing all aspects of audit activities including auditor training and coaching; periodic internal quality reviews and assessments; and external assessments of audit operations every five years.

As part of the QA&IP, the Audit Department recently conducted an annual internal assessment of Audit Department processes utilizing the IIA's quality assessment methodology. The principal objectives of the review were to provide reasonable assurance that the department's activities conform to the *Standards*, evaluate its effectiveness in carrying out its mission (as set forth in the Audit Department Charter), and identify opportunities to enhance management and work processes within the Audit Department. The assessment included review of audit risk assessment and planning processes; evaluation of audit policies, procedures, and practices; assessment of audit supervision methods; and detailed examination of selected audit work papers and audit reports in comparison with professional standards.

Quality Assessment

The Audit Department's processes are well established and founded on the principles established in the *Standards*. Further, the audit staff has a sound understanding of the *Standards*, and Audit Management has placed a priority on utilizing efficient audit tools that help maintain professional competencies. Among these tools and practices are automated audit work papers; a highly qualified audit staff; well written audit reports with a focus on risk; and an emphasis on professionalism that is evident in communications with clients. The comments and recommendations below are intended to build on the strong foundation already in place. Additionally, it should be noted that several comments and recommendations relate to Audit Management resources, which were affected by a staff member's extended leave during the year.

The quality assessment concluded that the Audit Department “generally conforms” to each section of the *Standards* and the Code of Ethics, which is the highest ranking possible. According to the IIA’s Quality Assessment guidelines, “generally conforms” means the Audit Department’s policies and processes are judged to be in accordance with the *Standards* with some opportunities for improvement. Specifically, the report noted the Audit Department partially conformed to four individual *Standards*, and also identified several recommendations related to Practice Advisories, or best practices. We concur with all the observations and recommendations (detailed below), which we believe will further strengthen the professionalism of the Audit Department. Further, we are in the process of preparing a Management Response and Action Plan to address these recommendations.

Comments and Recommendations

These observations are specific to the Audit Department’s impact on corporate governance, compliance with policies and procedures and enhancing Audit Department effectiveness.

STRENGTHEN CORPORATE GOVERNANCE

Audit groups contribute to the governance of an organization by providing independent and objective assurance to the Board and Management. The Audit and Ethics Committee reviews and approves the Audit Department’s annual Audit Plan to ensure appropriate deployment of audit resources.

The assessment revealed that due to changes in risk profiles and resource levels, some audits in the approved 2009/10 Audit Plan were not performed. Additionally, several lower risk audits were performed that were not included in the original Audit Plan. Changes in risk profiles and other modifications were not documented in interim reviews of the Audit Plan and Audit Plan status was not always formally communicated to the Audit and Ethics Committee for review and concurrence.

Periodic assessment of changes in audits’ risk profiles, additions to the Audit Plan, and changes in department resource levels should be documented and communicated to the Audit and Ethics Committee. Further, professional audit standards require that the General Auditor communicate “significant changes” to the Plan and the impact of resource limitations upon the Plan.

Response:

We concur with these observations and plan to include the changes made to the Annual Audit Plan in the quarterly update to the Audit and Ethics Committee.

COMPLIANCE WITH POLICIES AND PROCEDURES

In order to ensure high quality and professional audit work consistent with the *Standards*, auditors should conform to established Audit Department policies and procedures. Established procedures in such areas as audit planning and audit field work ensure that resources are properly allocated and audits are performed in an efficient and effective manner. Additionally, audit work should be properly supervised to ensure objectives are achieved, quality is assured, and staff is developed.

Detailed review of a sample of audit work papers indicated that in some instances audit conclusions could be enhanced by ensuring they were clearly supported by relevant data in the work papers. Further, planning and field work activities were not sufficiently documented in one instance.

Additionally, evidence of audit supervision, such as approving audit planning documents and work programs, could be improved. In two instances, supervisory authority did not appear to have been specifically assigned, partially due to Audit Management's resource limitations. In these cases, audit reports were issued without proper supervisory sign off of work papers as having been reviewed and approved.

Response:

We concur with these observations and will develop a plan to strengthen our compliance with Audit Department policies and procedures. We plan to remind auditors of the need to comply with established procedures in order to ensure quality work. We also will modify internal training materials to emphasize these points. Lastly, we will continue to perform annual internal assessments to ensure continuous improvement in these areas.

ENHANCE AUDIT DEPARTMENT EFFECTIVENESS

Audit Departments should document internal practices in order to provide guidance to auditors and establish feedback loops to assess compliance with these practices. In this manner, Audit Departments should continuously improve their internal operations in order to increase their value added. Further, auditors should enhance their knowledge through training in order to keep their professional competencies current.

While a comprehensive Audit Policies and Procedures Manual exist, it should be periodically reviewed and updated. Recent changes in the Audit Department's reporting structure to the Audit and Ethics Committee and other internal audit process changes result in the need to update the Manual. While efforts to update the Manual were initiated earlier, the update was not completed due to previously mentioned resource limitations. Additionally, the documentation of ongoing quality activities, including monitoring compliance with continuing professional education, could be enhanced.

Response:

We concur with these observations and will update the Policies and Procedures Manual by end of the calendar year. Further, we will enhance tracking mechanisms related to continuing professional education and other ongoing quality improvement activities.

Official Statement for the Water Revenue Refunding Bonds, 2010 Authorization, Series B

The Audit Department has completed a review of the Official Statement for the Water Revenue Refunding Bonds, 2010 Authorization, Series B. This review was undertaken to provide the underwriters of the Water Revenue Refunding Bonds (Bonds) "comfort" that the Official Statement for the Bonds is complete, consistent with supporting financial records, and accurate in all material respects. The review was completed and no exceptions were noted. We issued letters describing the agreed-upon procedures, and the results obtained to the underwriters of the Bonds.
